Introduction

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In recent decades, the financial sector has undergone a major shift from ‘boring banking’ (Krugman, 2009) to ‘financialization’ (Krippner, 2005). While boring banking was characterized by simple deposit and loan transactions, the term financialization captures the trend toward securitization of loans (and other financial products) to be traded on secondary markets. It has led to the development of complex financial instruments such as derivatives, the intensification of international capital flows and an increasing share of corporate profits going to the financial sector (Nölke et al., 2013). While in the period of boring banking (the post-war period until the mid-1970s) the banking system was stable, with the onset of financialization financial markets have become volatile. The volatility of the financial system has destabilized many economies, with detrimental effects on employment, working conditions and social security schemes (Herr et al., 2014).

The severity of the recent financial crisis starting in the United States in 2007 has led to calls for a more sound financial system and subsequently to more strict regulation of banks in the United States, in Europe and other places. Critics of financialization, however, have found that the reforms fall short of what is necessary for a stable financial system since the core of financialization – securitization – has remained virtually untouched (Helleiner, 2014; Scherrer, 2016). Therefore, some critics have called for strengthening alternative banks, which are banks owned by cooperatives or by public entities such as municipalities or state governments. These banks are said to be more prudent in their risk-taking, more long-term oriented and in general more attuned to the public good; most importantly, they have weathered the crisis rather well (Butzbach and Mettenheim, 2014).

While cooperative banks have received rather scant attention, banks owned by municipalities, state governments or other public entities (referred to here as public banks) were the target of much criticism before the crisis of 2007. The International Monetary Fund spearheaded the critique of public banks. On its advice, many countries privatized the public banks in the 1990s (Marston and Narain, 2004). The IMF continued this critique
into the 2000s. For example, in its Financial System Stability Assessment, the fund recommended that Germany facilitate market-oriented restructuring by allowing private banks to take over public savings banks (IMF, 2003, p. 4). In academia, adherents of the principal–agent theory provided the scientific rationale against public banks. Lacking the discipline of the market, public banks are either misused by their owners (principals) for political purposes or by their management (agent) for aggrandizement (La Porta et al., 2002).

During the crisis, policy elites changed their perception of the state’s role in financial markets. Many banks were nationalized and the government infused new capital or provided large-scale loans and guarantees (Contessi and El-Ghazaly, 2011). It seemed as if the delegitimization that the private banks had suffered from their reckless behavior would relegitimize public banks. The government crisis measures, however, turned out to be ad hoc crisis interventions. They were not done with the intention of rebuilding the public banking sector (ibid.).

The call for expanding and strengthening public banks went unheeded. The question is whether this neglect is justified or a product of interest constellations and ideological blinders. This book is intended as an exploration of the role public banks could play in stabilizing the financial system and in serving the ‘real’ economy with financial services. It aims at understanding how public banks fared in the current crisis. Do public banks serve as stability anchors in financial markets? Do public banks provide the much-needed finance for development? Against the background of the prevalent critique of public banks as politicized, badly managed financial entities, contributions to this volume will ask the following questions: Does the governance structure differ between the sound and the reckless public banks? What kind of governance keeps public banks accountable to the public? To these questions the book provides answers. It combines theoretical treatment of the issues raised with empirical investigations.

The empirical analysis will focus on three very different countries that share one similarity, namely the presence of a significant public sector in banking: Brazil, Germany and India. In 2013, the share of public banks was about 51 percent in Brazil (EMIS, 2014, p. 6), 40 percent in Germany (Bankenverband, 2014, p. 6) and 75 percent in India (see Chavan, Chapter 7 in this volume). Given the significant differences among these countries, this volume will not compare their public sectors in a strict sense. Rather, the differences are used to elucidate certain specific functions, performances and challenges of public banks. The case of Brazil allows for the study of a function seldom attributed to public banks, namely stabilizing the financial sector via anticyclical policies. As such anticyclical policies were pursued under the Lula presidency (2003–10), one can analyze the degree to which
they were successful in stabilizing the economy and whether they came at the expense of deteriorating quality in bank loan portfolios. Brazil is also home to one of the world’s largest development banks, BNDES. An analysis of its performance since the early 1950s promises insights into the factors driving its activities and influencing its performance.

Germany, as one of the places where public banking began, lends itself to an analysis of the early motives for public banks and their subsequent performance. Since Germany remains one of the very few countries among the more economically advanced countries with a large public banking sector, it is a good place to look at the role and performance of public banks in mature financial markets. Despite or because of their overall good record, they have come under attack from private banks using the competition policy doctrine of the European project of a single market in the 1990s and recently the post-crisis regulation proposals in the form of a Banking Union. These attacks are a good opportunity to explore the political vulnerability of public banks. Since not all German public banks were performing equally well, a comparison between successful and failing banks allows for insights into the factors that determine performance. Since the less well-performing banks in particular had jettisoned any reference to a public mandate besides increasing the competition in financial markets, the German public banks are good study objects for the issue of mission creep, that is, why public banks might lose sight of their public mandate and what could be done about it.

Since the broad-based nationalization of private banks in the late 1960s, India has been a country with one of the largest public banking sectors. It is therefore a good place to study the achievements and challenges of a largely publicly controlled financial system. India is also a country with historically high levels of unbanked households. The issue of financial exclusion and what public banks can contribute to increase the levels of inclusion can thus be discussed. Its banking system also allows us to study an important challenge for public banks, namely non-performing loans.

The main insights gained from these case studies can be summarized in the following way. Beyond supporting their regional economies by providing patient money and expertise, public banks can stabilize the business cycle through their long-term orientation and short-term mobilization of liquidity for countercyclical investment and consumption. They also increase the level of financial inclusion by reaching out to low-income households. As even mature financial markets do not provide these kinds of services, public banks are also valuable for economically advanced countries. Despite or because of their social functions, public banks perform on average better than their private counterparts in these countries, even measured in terms of traditional managerial objectives such as
profitability and cost efficiency. In sum, public banks can perform important functions for an economy without having to rely on risk-prone financial instruments. Strengthening the role of public banks in the financial system could contribute significantly to stabilizing it.

Yet, public banks are also prone to mission creep. They are sometimes misused for narrow, self-serving political purposes, for aggrandizing their management or by powerful debtors. To safeguard public banks against losing sight of their original mission, neither changes in the incentive structure for their management nor institutional fora for public deliberations will suffice. In addition, it is necessary for management’s as well as politicians’ perception of the mission of public banks to change. This calls for a much broader debate about the role of the public sector and the limits on private actors. It calls into question the underlying concepts and practices of financialization, starting with academia and not stopping at Wall Street.

SUMMARY OF CHAPTERS

The book is divided into five parts. The first part, ‘Justifications for Public Banks’, contains two contributions that provide reasons for the existence of public banks – the one more theoretical and the other more historical. The title of the first contribution (Chapter 1) already hints at an overlooked *raison d’être* for public banks: ‘Beyond the market failure argument: Public banks as stability anchors’. Ana Rosa Ribeiro de Mendonça and Simone Deos from the Universidade Estadual de Campinas (Unicamp) in Brazil argue that limiting public banks to filling the gaps left by private banks – the standard argument in economics – neglects a very important dimension of public banks, that is, their capacity to act countercyclically and thereby stabilize access to credit during economic downturns. Taking a cue from Hyman Minsky, they point to the immanent volatility of financial markets dominated by private actors. In order to counter destabilizing tendencies, the presence of institutions with a logic of action that differs from that of the market is necessary. As public banks are not primarily concerned with profitability, they can play this role. To a certain extent, their presence in the market is an automatic stabilizer because public banks provide credit with long maturation. In times of crisis, they can also be used for discretionary intervention, that is, opening up new credit lines.

In their contribution, ‘Back to the future of alternative banks and patient capital’ (Chapter 2), Kurt Mettenheim from the Getulio Vargas Foundation in Brazil and Olivier Butzbach from the University of Campania ‘Luigi Vanvitelli’ in Italy explore the genesis of alternatives to private banks, that is, savings banks, cooperative banks and development
banks in the nineteenth century. They interpret the establishment of alternative banks as social reactions of self-defense in Karl Polanyi’s sense. The strengths of these alternative banks are rooted in what they call patient capital. Financial investments can be called patient when they are not made in expectation of short-term profits but in anticipation of more substantial returns in the future. Patient capital actually provides alternative banks with a competitive advantage, for which the authors provide proof in the form of an extensive statistical analysis of historical data as well as data from 2006 to 2012. The success of alternative banks in recent years helps them argue that although reforms have marginalized alternative banks in liberal market economies, liberalization produced back-to-the-future modernization of patient capital practices at alternative banks in coordinated market economies.

In the second part of the book, ‘Public Banks as Stability Anchors: Case Studies’, the previously theoretically underpinned claim that public banks can counteract the volatility of financial markets is empirically explored through the behavior of public banks in Brazil and Chile during the financial crisis of 2008. The first contribution, ‘Facing the 2008 crisis: Brazilian Central Bank and public banking system as Minskyan “big banks”’ (Chapter 3), by Simone Deos and Ana Rosa Ribeiro de Mendonça, picks up on Hyman Minsky’s concept of a ‘big bank’, that is, the central bank as a lender of last resort, which together with big government stabilizes the economy. According to the authors, the provision of liquidity in order to avoid the financial crisis can be performed by a group of public banks in coordination with the central bank, thereby jointly playing the role of big banks. Empirically, they show that the impact of the 2008 crisis on the Brazilian economy was rather limited because the Brazilian Central Bank together with the public banks supplied sufficient liquidity for non-financial agents. Specific institutional characteristics of the Brazilian financial system have allowed these big banks to react promptly to the crisis.

The second contribution to this part of the book, ‘Federal public banks in Brazil: Historical overview and role in the recent crisis’ (Chapter 4), by Simone Deos and her co-authors Camilla Ruocco and Everton Sotto Tibiriçá Rosa (Unicamp), complements the first by providing a historical overview of two important Brazilian public banks, Banco do Brasil and Caixa Econômica Federal. It also details their anticyclical interventions during the crisis, which did not lower the quality of their respective portfolios. Only the shift to restrictive macroeconomic policies well after the crisis in 2014 has offset the expansion of public credit. The authors draw lessons from this: the anticyclical credit instruments have to be better coordinated with macroeconomic and currency policies.

The last contribution to the issue of public banks as stability anchors
Public banks in the age of financialization

(Chapter 5) is written by Ana Rosa Ribeiro de Mendonça and Brunno Henrique Sibin (Unicamp). ‘Public banks and recent anticyclical policies: A comparison study of the experiences of Brazil and Chile’ analyses the parallels between the crisis response of the Brazilian public bank Caixa Econômica Federal (Caixa) and its Chilean counterpart BancoEstado in their different political and economic environments. Both banks acted anticyclically, but encouraged by the strong pro-growth orientation of the Brazilian government and enabled by the institutionalized access to compulsory savings funds, Caixa continued the expansion of lending even after the crisis had been overcome. This procyclical behavior is a sign that Caixa’s mandate went beyond the function of a stability anchor.

Part III, ‘Public Banks and Development’, takes a look at one of the major functions of public banks, namely the support of economic development. Its first contribution (Chapter 6), ‘The role of the Brazilian Development Bank (BNDES) in Brazilian development policy’, by Adriana Nunes Ferreira and Everton Sotto Tibiriçá Rosa (Unicamp), traces the history of one of the largest development banks in the world, Banco Nacional de Desenvolvimento Econômico e Social. In its various phases since the 1950s, the history of BNDES has mirrored the vision of development held by the leaders of the Brazilian economy. It moved from support for industrialization based on import substitution to relieving private companies of their foreign-denominated debt, to facilitating privatization and finally to carrying out industrial policy initiatives. While it undoubtedly contributed to economic growth in Brazil, the country has yet to fulfill the original vision of development with an endogenous technical progress and social justice.

The second contribution (Chapter 7) to the issue of development, ‘Public banks and financial intermediation in India: The phases of nationalization, liberalization and inclusion’, written by the Indian economist Pallavi Chavan, looks at one of the biggest public banking sectors in the world, also from a historical perspective. Besides supporting employment-intensive sectors such as agriculture and small enterprises, Indian banks are charged with reaching out to a great number of people without bank accounts, especially in rural areas, since the broad-based nationalization of banks in the late 1960s. Until the financial liberalization phase in the 1990s, branch outreach increased rapidly and bank credit became much more accessible in agriculture. The expansion of public banking was accompanied by a striking increase of national savings and investments. However, the policy of financial liberalization brought about a reversal in most of these accomplishments. The policy of financial inclusion and low interest-bearing loans to address agrarian distress resumed after 2005, but also included bulky loans to infrastructure and core industrial sectors with
a higher propensity for default. Rejecting the call for privatization, she asserts the need not only to preserve the public character of these banks by way of recapitalization given their role in financial inclusion but also of a professional and transparent management of these banks.

The last contribution under the heading of development explicitly deals with the topic of good governance of development banks: ‘Governance of development banks under uncertainty’ (Chapter 8) written by Tamilla Tagieva from the University of Kassel in Germany. The contribution makes use of the sociological literature on organizations to answer the question of how a development bank can fulfill its public mandate of promoting industrialization under the conditions of uncertainty typical for many countries trying to catch up economically. With references to the internationally active German development bank KfW the author comes to the conclusion that development banks can successfully pursue their mission, even under conditions of uncertainty, if their board includes stakeholders beyond the government, if they can diversify their sources of capital, and if they strengthen their own knowledge in creating and learning capacities. These measures could increase their input as well as output legitimacy and thereby strengthen their standing in society.

The fourth part of the book, ‘Political Attacks on Public Banks in Europe’, picks up on the political vulnerability of public banks with the example of German public banks. Its first contribution (Chapter 9), ‘Savings banks and Landesbanken in the German political economy: The long struggle between private and public banks’, is written by Daniel Seikel from the Institute of Economic and Social Research (WSI) at the German Hans-Böckler Foundation. It introduces the reader to the traditional structure of the German banking system, the role of the public banks therein, and the relevance of this structure for the German production regime. It then traces the conflict between private and public banks as the latter increasingly competed for the same business. The conflict stalemated in the national arena until the European Single Market project was launched. This offered the private banks the opportunity to bypass the strong opposition in Germany. As European competition law presumes that all actors act like profit-maximizing private investors, the state liability guarantee for German public banks was considered to be an unfair competitive advantage. Under the dictates of the European Commission, this guarantee had to be withdrawn by the year 2005.

This part’s second contribution, ‘Marginalizing the German savings banks through the European Single Market’ (Chapter 10), picks up where one timeline ends and another begins. Its author, Halyna Semenyshyn from the University of Kassel, addresses the questions of how and why the German public banks are once again threatened by the European Single
Market project despite the good performance especially of the municipal savings banks during the crisis of 2008. The Banking Union as envisaged by the European Commission will force savings banks to abandon their own joint liability schemes in favor of a more expensive European Union scheme. This disregard for alternative banking models stems from the continuing predominance of neoclassical economic thinking within the European Commission, despite its delegitimization in the crisis of 2008 and the fact that after the privatization wave of the 1990s, the German public banks were left with few allies among the European member states. But it is also the result of the massive losses incurred in another section of German public banking: the regional state banks or the Landesbanken. Their failure to adapt to the loss of the state liability guarantee placed the whole public sector on the defensive.

In the book’s last part, ‘Keeping Public Banks Accountable to the Public’, the recurring issue of the previous parts – the public mandate – is covered from different perspectives by four contributions. In the first contribution (Chapter 11), ‘Governance makes a difference: A case study of the German Landesbanken Helaba and WestLB’, Xeniya Polikhronidi and Christoph Scherrer from the University of Kassel take aim at the German regional state banks, the Landesbanken mentioned in Part IV. By comparing an ambitious but ultimately failing Landesbank (WestLB) with a more prudent and so-far successful Landesbank (Helaba), they analyze the impact of governance structures on the performance of public banks. By applying a multi-theoretical perspective, they find that the governance of these banks differed remarkably in terms of processes, which may explain the different fate of these Landesbanken to a large extent. While both banks suffered a major crisis in the 1970s, the owners of Helaba learned their lesson and set up a governance structure characterized by strict control and monitoring mechanisms. They also upheld the commitment to a public mandate. At WestLB, this commitment was dropped and the governance structure left management with a very high degree of autonomy.

The problem of Indian public banks with non-performing loans, already mentioned in Part III, receives special attention in the contribution by Meenakshi Rajeev from the Institute for Social and Economic Change in India: ‘Changing structure of non-performing loans: The case of Indian public banks’ (Chapter 12). In her historical account of non-performing loans on the books of banks, the early years after nationalization are characterized by neglect of the problem. Only after the liberalization of the banking sector did the banks start to take serious measures to reduce the number of non-performing loans, whereby the public banks were as successful as their private counterparts. However, in the recent decade the problem resurfaced when the share of loans to large corporations
Introduction

increased. Based on field interviews, Rajeev identifies a number of reasons for non-payment, some of which pertain to the low collateral recovery rates in the courts, and others to the insufficient bank monitoring of borrowers. In contrast, self-help groups enhance the loan recovery rate in the poorer sections of society.

The third contribution (Chapter 13) on governance looks at alternative banking models in the form of microfinance institutions: ‘The stakeholder governance of microfinance’. Its author, Magdalena Dieterle from Bremen University of Applied Sciences in Germany, argues that stakeholder-based financial institutions with supportive governance structures and local ownership (whether explicit or implicit) can offer more healthy and stable growth, even in times of crisis, for the institutions, their customers, and the communities in which they are based. This claim is based on a look at the history of microfinance that goes back to Irish loan funds and an analysis of today’s microfinance institutions, especially those with a sense of client ownership.

Finally, Christoph Scherrer explores what leads public banks to disregard their public service function and how one can prevent this disregard in his contribution, ‘The challenge of keeping public banks on mission’ (Chapter 14). Again taking the German public banks as an example, it briefly describes their ‘mission creep’ in the form of financialization. Guided by the theory of hegemonic discourse, he interprets mission drift as part of neoliberal hegemony. This leads him to be skeptical about technocratic organizational solutions to the problem. From his discourse and analytical point of view, awareness about the public mandate seems to be of utmost importance. If the key actors of public banks are not aware of the public mandate and do not identify with the public mandate, then staying within the public mandate cannot be expected. Therefore, he argues that one needs to start with the general debate about the content of the public mandate and how public banks can contribute to it.

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